In the Matter of:	)	
	)	
	)	
Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers	)	WC Docket No. 03-173

To: The Commission

COMMENTS OF WELSH GROUP, LLC

1. Welsh Group, LLC respectfully submits its comments in the above referenced proceeding. Welsh Group is a consulting firm providing services to telecommunications companies nationwide. These services include assisting with long-lived asset accounting issues, preparing depreciation studies and related regulatory issues.

2. Welsh Group would like to comment on several of the depreciation expense questions raised in this docket. In general, recovery of invested capital is one of the largest expenses in the TELRIC model. In prior TELRIC proceedings, at both the federal and state level, recovery has largely followed the regulatory model since regulators were unwilling to support the GAAP accounting model advocated by the telephone companies. The argument on both sides of the depreciation debate is that the lives they recommended are better forward-looking lives than the other side. This debate has largely ignored the fundamental fact that both the regulatory lives and GAAP lives were developed primarily to recover a large embedded investment not the "fresh start" investment in the TELRIC model. This difference has resulted in numerous efforts to twist traditional depreciation and accounting concepts and principles to "fit" the TELRIC model. It is encouraging that the Commission is addressing this difference in this docket.

3. In paragraphs 92 and 93 the NPRM states that economic depreciation is a method of reflecting anticipated declines in the net value of an asset over its useful life and that if equipment prices decline then the value of equipment currently in use should decline at the same rate. In the *Local Competition Order* the Commission stated that depreciation schedules should take into account expected declines in the value of goods. Commission rules require the use of "economic depreciation" and in the *Triennial Review Order* the Commission allowed a carrier to accelerate recovery of the initial capital outlay to reflect anticipated declines in value. Collectively the Commission is clearly saying that it prefers depreciation expense that reflects declines in value rather than a systematic recovery of the invested capital.

4. In paragraphs 102 to 108 the Commission expands on the value concepts and solicits opinions on mechanics of making the process work. In Welsh Group's opinion, the Commission is mixing two concepts which we believe should be treated separately. First, depreciation expense should be a systematic and rational recovery of the capital outlays. This process should ensure that over the expected useful life of the asset the original investment in the asset is fully recovered. In the telecommunications industry few assets provide value over the full physical life of the asset. Usually technology change and competition force a retirement long before the end of the physical life. The second concept is valuation, which measures the current market value of assets. Valuation considers the change in equipment prices and comes closest to the economic depreciation advocated by the Commission.

5. There are uncertainties in depreciation and more in valuation. Welsh Group would recommend that the Commission treat each of these concepts separately in TELRIC. UNE pricing should ensure the opportunity to recover investment in the Network. Without this, there is little incentive for the incumbent LEC to invest or even maintain the current network. Rather the LEC should prefer to invest in new services outside the TELRIC framework. UNE pricing

should then consider the valuation component as an overlay to ensure the overall level of depreciation expense reasonable and reflects the competitive market. Theoretically, the correct useful life should cover both of these components since only the original cost of an asset can be recovered. However, economic depreciation also requires the correct pattern of recovery. Most telephone companies use a straight-line methodology that evenly spreads the depreciation expense over the useful life for financial and regulatory reporting even though GAAP allows other accelerated methods. Since the straight-line pattern is seldom the case in real life, this creates differences between accounting depreciation and economic depreciation. Although the Commission may prefer economic depreciation, it needs to recognize that any methodology based on the subjective future value of a network provides significant opportunities to create a level of depreciation expense that could distort the very market incentives that TELRIC is designed to promote. For example, some could argue that the increasing pace of technology change and rapid expansion of competition requires an accelerated method and/or very short useful lives to ensure recovery. Others could argue with that economic value of network will not substantially change for several years. If so, then longer lives may be more appropriate or an allocation method that allocates more recovery to future periods when the decline in value is expected. These two very different views could result in significantly different depreciation expense levels which could benefit one group at the expense of another. The Commission should endorse a methodology that is fair to all parties and limits the opportunities to "play with the numbers". Separating the capital recovery portion of depreciation expense from valuation portion would promote a more meaningful dialogue in this area and minimize the process favoring one party over another.

6. The remainder of our comments will address individual questions in the NPRM in light of our general comments.

Paragraph 94

7. Paragraph 94 states that the useful life of an asset is determined by comparing the operating cost of the existing asset with the operating cost of a new asset plus the investment cost of the new asset. In this view, if the total cost (operating and recovery of original cost) of the new asset is less than operating cost of the old asset then the company would want to replace the asset and end its useful life. This approach assumes that the original cost of the old asset is a sunk cost and not part of the investment decision. Welsh Group questions whether this definition of useful life is appropriate for TELRIC. In the TELRIC model the initial capital costs reflect a most efficient network and there is little need to consider any significant replacement of assets since the planning period is less than the useful life of the majority of the assets. A better definition of the useful life of an asset is the period of time that the asset generates revenue that cover its operating expense and the recovery of its initial capital cost. This definition matches the recovery of the invested capital to the revenue generating capacity of the asset. It also makes the useful life a function of the asset not the investment replacement decision which may or may not occur.

Paragraph 98

8. In Paragraph 98 the Commission states its concern that replying on financial reporting lives might permit companies to adopt depreciation methods that result in excessive depreciation expense. Is this reluctance warranted? Welsh Group believes that some reluctance is warranted but not for the concern expressed by the Commission. Financial reporting lives reflect a company's best estimate of the useful of the assets currently deployed by the company. As such these lives may or may not be appropriate for TELRIC since TELRIC should reflect lives of

newly placed plant, not embedded investment that may have been in service for many years.

9. In prior UNE proceedings there are numerous references to the depreciation term projection life which is defined as the expected life of newly placed plant. However, projection life is also a generalized term used in traditional depreciation proceedings such as the "three-way" process used by the Commission to set prescribed depreciation rates. When used as a general "term of art" the project life allows companies and regulators to have a common reference point that is unaffected by the survivor curve and age distribution of a particular account in a particular company. Sometimes the two different uses of the projection life result in the same useful life estimate. For example, Motor Vehicles usually have the same life under both definitions since newly purchased vehicles are expected to have the same life characteristic as the old vehicles that have been used for many years. But, in accounts impacted by technology change, as in many TELRIC accounts, lives should be based on the expected average remaining life (ARL) of the investment since the life characteristics of the new investment are usually different than life characteristics of the old. For example, in central office accounts the life of equipment purchased when a new technology is initially deployed is much longer than the life of the same type of assets purchased late in the life cycle. When the appropriate ARL is determined the projection life associated with that ARL will vary based on the age of the investment in a particular company and the expected pattern of future retirements. For example, if the appropriate ARL for a group of assets is 5 years, then the projection life in one company may be 10 years and 12 years in another. For financial reporting one company would use 10 years and the other company 12 years. It would be incorrect to assume the company using 10 years is being more aggressive since both companies are making the same estimates about the future use of these assets. For UNE pricing the 10 year projection life would be appropriate for both companies. Thus the Commission should be reluctant to use only financial lives because of the role embedded investment plays in their development. UNE pricing should use lives that

accurately project the future expectation for the assets. In some accounts this would suggest the useful lives for UNE ratesetting may be shorter than the lives used for financial reporting.

10. Also in Paragraph 98 the Commission asks if the financial lives used for external reporting match those used to plan future capital expenditures. Welsh Group believes the correct answer is "yes" and "no". Financial lives are set for large groups of assets, for example, all circuit equipment. Capital expenditures are usually planned and approved at a much lower project level of detail. In one project the circuit equipment may be expected to have a four year average life. In another project it may be ten years. The four years and ten years are appropriate for each individual project and the financial life of eight years would be inappropriate. However, a third project may have a range of circuit equipment and the eight years would then be appropriate. In the development of the eight year financial life the company would consider the fact that some equipment is expected to have a short life and some a longer life. Periodic reviews of the financial life would adjust the life longer or shorter based on mix of equipment in the account. So the financial lives and the capital planning lives are linked and consistent with each other when viewed in the proper context.

Paragraph 99

11. In Paragraph 99 the Commission seeks information on how financial lives are developed and if they accurately represent the anticipated economic life of assets. GAAP requires a company to use lives that reflect the expected useful life of the assets. These lives are economic lives since they match the period in which the assets provides value with the period the asset's original cost is recovered. If a company attempts to use lives that are too short, the company is penalized in the market place because of low earnings and prices that are not competitive. If a company attempts to use lives that are too long, it runs the risk of being unable to recover its

investment. In addition, GAAP requires the company to recognize immediately any impairment. Assets are impairment when the future revenue stream is less than the carrying cost (net book) of the assets.

12. In developing financial lives most companies consider: the past and current network modernization strategies; the impact of technology and obsolescence; the competitive environment in the marketplace; regulatory commitments; state demographics; and traditional wear and tear. Depending on the particular asset group the emphasis on the factors shift. For example, for motor vehicles, modernization strategies and traditional wear and tear are predominant. For outside plant cable, technology and competitive impacts are predominant. Few companies today prepare detailed depreciation studies as required by the Commission in the triennial three way meeting process since so many of the exhibits in the traditional study focus on historical information. Most companies limit their depreciation studies to the items necessary to support their life selections to senior management and their external auditors. For some accounts where historical experience is a good indicator of future expectations some traditional exhibits are prepared and reviewed. However, most accounts are subject to technology change and competitive pressures which require companies focus on: technology and competition studies prepared both internally and by independent companies; industry benchmarking; internal and external subject matter experts; and company strategic plans. Embedded in this process is a review of future technologies. For example, most of the LECs reflected the expected impact of DSL in their copper cable lives long before the first DSL customer. Similarly, most LECs reflect the substitution of wireless for wireline voice calls in their asset lives.

13. The Commission also asked about how relevant actual retirement experience, depreciation reserves and projected investment plans are in setting economic useful lives. Actual retirements have little life setting impact for most accounts for two reasons. First, actual

retirements are a function of the Part 32 accounting rules. That is, a 100 pair cable remains in service until the last customer moves off of the last pair. This creates a life that maybe many years longer than the economic life since the economic useful life would end when the revenue from the 100 pair cable no longer covers the expenses associated with the cable. In the old rate of return environment when the ILECs controlled the marketplace and the market was growing this was not an issue. Now with declining usage of the ILEC networks this erosion of the economic value of assets is hidden because low utilization does not generate accounting retirements.

14. The second reason actual retirements have little life setting impact is the expected retirement pattern for a group of assets. For example, copper cable retirement levels are very low in most companies. However, this does not mean copper cable will have a long future life. Rather it reflects that most copper cable is needed today and most of the unused cable has not triggered an accounting retirement. Tomorrow copper cable will be replaced by fiber cable and other media such as wireless. As these new networks evolve the copper retirements will remain low (although utilization of the network will decline as customers migrate to the new networks). Then almost over night the copper network will become obsolete and the companies will experience high accounting retirements. The Commission should place little weight on retirement history. Given the rapid pace of technology change and the growing competition faced by all telephone companies the past is no indicator of the future.

15. Depreciation reserves have some meaning in a financial reporting or regulatory reporting environment since they can help determine if a company has been properly depreciating its embedded investment. However, depreciation reserves need to be used with care since the level in itself is not a good indicator of the validity of the life estimate. The reserve level is a function of depreciation decisions in the past and the age of the assets within the group. In general,

reserve levels increase as assets age and assets early in their life cycle have low reserves and assets late in their life cycle have high reserve levels. Thus any reserve level may be appropriate or inappropriate depending on many factors. In TELRIC, reserve levels should be a moot point since the network is all newly placed investment which by definition has no reserves. Basing life estimates on reserve levels would be like driving by looking at the rear view mirror.

16. Considering the projected investment plans of the company and its competitors is part of selecting appropriate economic useful lives. Company decisions to deploy new technology to improve service, reduce cost, or response to a competitive threat all have a direct impact on the life estimate. For example, if a company decided to aggressively deploy fiber broadband capabilities in its network, the company would be shortening the expected life of its narrowband copper based network. However, the opposite may not be true. If instead of the company, a competitor aggressively deployed a fiber based broadband network, the impact on the company's narrowband copper based network would be same as if the company deployed the new network. That is, the company would need to shorten the expected life of the copper based network.

17. Is there other objective information the Commission should consider in selecting appropriate economic useful lives? Yes. Welsh Group believes the Commission should seriously consider benchmarking competitive companies and other industries for selected accounts. The Commission should also consider technology studies by independent companies. Often the best views of the future are with independent companies specializing in forecasts industry technology and competitive trends. Benchmarking would also be useful since there is no reason to believe the fiber cable in a local telephone company, a long distance telephone company or a cable TV company should have different lives now that both are competing for the same customers and providing comparable services.

Paragraph 101

18. In Paragraph 101 the Commission is requesting comments on the current FCCC regulated lives. Welsh Group believes the current FCC lives are no longer reasonable for regulatory reporting and especially for TELRIC. The current FCC ranges were developed in the mid nineties based on data collected by the Commission in the early nineties. The prescribed lives underlying the FCC ranges reflect a rate of return environment that no longer exists. If prescribed lives still had meaning, the ILECs would have sought to update them. However, no company has submitted studies to update their FCC prescribed lives in years. Nor has any LEC felt the need or seen a benefit in electing the wavier process set up by the Commission in 1999.

19. In the environment in which the current FCC ranges were established the Commission considered technology change and competition, but the focus was on retirements and reserve levels. The ranges do not fully consider the significant changes that have occurred in the last ten years. In particular, the ranges did not anticipate the Telecommunication Act of 1996 and its impact on competition. The ranges did not anticipate the impact of the internet and the voice over IP which is starting to become a serious competitor to traditional telephone service. The ranges did not anticipate the convergence of technologies which now have wireline, wireless, cable TV and satellite provides all competing to provide the same services to the same customers.

20. The Commission could use the current FCC ranges as a starting point. But significant adjustments should be made to bring the ranges in line with the environment facing the industry today. Even so, the ranges would still not be appropriate for UNE pricing as discussed earlier. The ranges are for a blend of old and new investment. UNE prices should only be based on appropriate lives for new investment.

Respectfully submitted,
Robert N. Welsh
President